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Economic Outlook

Irving Trust

Irving Trust Company
One Wall Street
New York, NY 10015

Economic Research &
Planning Division

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Oil is the big story these days. The price collapse has sparked yet another bond market rally, has raised consumers' hopes about a return to the good old days of low gasoline prices, but has also created severe problems for Mexico and for certain other countries, as well as for certain segments of U.S. industry. On balance, it improves the prospects for sustained economic expansion in the United States with relatively low inflation.

Oil prices had already been declining for several years before the recent plunge. The average refiner acquisition cost of crude oil (which includes both domestic and imported oil) fell from $35.24 per barrel in 1981 to $28.63 in 1984, a decline of 18.8%. During this same period, gasoline prices in the consumer price index fell only 9.9%. Last year, the refiner acquisition cost averaged about $27 a barrel. A refiner acquisition cost of $20-$22 this year seems likely, which would indicate a decline of roughly 20%-25%. Admittedly, some spot prices have declined more, but they have also been more volatile. For example, West Texas intermediate went from $25.75 a barrel in early 1985 to $30-$31 late in the year before plunging to as low as $15.75 recently.

If the 1981-1984 experience is any guide, gasoline prices will decline by only slightly more than half as much as crude oil prices. They may not even decline that much, since a mandated reduction in the lead content of leaded gasoline this year will push up refining costs. Since gasoline prices have a weight of about 5.5% in the consumer price index, the direct effect of a 10%-12% decline in gasoline prices is a reduction in the consumer price index of about seven-tenths of a percentage point from what it would be otherwise. The additional indirect effects of lower oil prices, however, are important and diverse.

As a rough guide to the importance of oil in the U.S. economy, the value of crude oil consumed last year was equal to 3.8% of GNP. A 20%-25% decline in crude oil prices amounts to about 1% of GNP, or a direct reduction in the GNP price deflator of one percentage point from what it would be in the absence of the oil price decline.

In 1985, the consumer price index rose 3.8% (on a December-to-December basis). The decline in oil prices would seem to indicate an inflation rate below last year's except that it will probably be more than offset by the inflationary effects of the depreciation of the dollar, which has amounted to about 20% on a trade-weighted basis since the peak early last year. As a result, the consumer price index is expected to rise about 4.5% from December 1985 to December 1986.

The decline in oil prices increases the odds that real GNP growth will be stronger in 1986 than in 1985. The economy displayed an unusually good performance in December, with retail sales, industrial production, and housing starts all registering sharp increases. January's performance was mixed. Although there was a strong 566,000 gain in nonfarm payroll employment, nonauto retail sales registered a disappointing 0.2% month-to-month decline. Nevertheless, if inventories show modest growth and if the trade deficit narrows in real terms as expected, real GNP in the current quarter may well be rising at the fastest pace since early 1984.

Bernard Schoenfeld

Irving Trust

Economic Forecast

Percent Changes at Annual Rates

	Actual				Forecast				Actual	Forecast
				1985				1986	1983-	1984-	1985-
	I	II	III	IV	I	II	III	IV	1984	1985	1986
Gross National Product	6.9	4.5	5.6	5.9	8.4	7.4	8.4	8.1	11.0	5.8	7.2
Real GNP	1.7	1.1	3.0	2.4	5.4	4.1	1.8	3.2	6.6	2.3	3.7
GNP Price Deflator	5.0	3.3	2.9	3.4	2.9	3.2	4.4	4.7	4.0	3.3	3.4

	Actual	Forecast	Actual	Forecast
	1985: IV	1986: I	1983-1984	1984-1985	1985-1986
Consumer Spending	4.2%	9.2%	8.7%	6.6%	6.7%
Durable Goods	-16.7	16.7	14.3	9.0	4.2
Nondurable Goods	6.7	4.7	8.8	4.6	5.1
Services	9.1	10.5	8.6	7.3	8.6
Business Capital Spending	10.5	8.5	20.1	11.2	7.6
Structures	8.0	6.3	17.0	15.2	5.8
Equipment	10.9	9.6	21.7	9.1	8.6
Residential Investment	21.1	8.0	17.8	3.6	8.1
			1984	1985	1986
Change in Inventories	$22.4b.	$7.0b.	$67.3b.	$9.1b.	$15.5b.
Net Exports of Goods and Services	$-97.2b.	$-94.0b.	$-59.2b.	$-74.4b.	$-87.0b.
			1983-1984	1984-1985	1985-1986
Government Purchases	10.6%	2.4%	9.0%	10.6%	8.3%
Federal	16.0	-2.8	9.4	13.1	8.6
Defense	3.9	4.0	9.9	10.3	7.5
Other	35.6	-19.0	8.8	20.9	12.0
State & Local	6.6	6.5	8.4	8.7	8.0
Corporate Profits Before Tax	14.7	12.0	28.9	-3.0	8.5
Corporate Profits After Tax	12.5	12.5	20.9	-2.9	7.7
Plant and Equipment Expenditures	0.1	5.1	16.3	8.4	2.4
Real Final Sales*	2.1	4.9	4.5	4.0	3.7
Real Disposable Personal Income	-0.2	3.8	5.7	3.6	2.4

Economic Indicators	Recent Data			Actual		Forecast
	Nov.	Dec.	Jan.	1983-1984	1984-1985	1985-1986
Consumer Price Index**	7.2%	4.8%	3.4%	4.0%	3.8%	4.5%
Producer Price Index for Finished Goods**	5.4	6.0	-8.4%	1.3	1.8	2.8
Industrial Production	0.8	0.7	0.3	7.1%	2.2	3.6
Retail Sales**	0.5	1.4	0.1	10.4%	6.3	4.7
				1984	1985	1986
Auto Sales (millions of units, a.r.)	9.4	10.3	9.6	10.4	10.1	10.6
Housing Starts (millions of units, a.r.)	1.97	1.85	1.96	1.74	1.81	1.89
Unemployment Rate	7.0	6.9	6.7	7.5	7.2	6.5
Merchandise Trade Deficit (a.r.)	$122.2b.	$108.8b.	[illegible]	$123.0b.	$122.0b.	$160.0b.

Unless noted otherwise, all data are period-to-period percent changes at annual rates, derived from seasonally adjusted data. [illegible], 1986

*GNP less change in inventories, both in real terms.
**Monthly percent changes are not annualized.
*Year-over-year percent changes.
**Annual percent changes are December-to-December, not seasonally adjusted.
$b. = billions. a.r. = annual rate. F = Forecast.